United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

76-5020

To be argued by
DAVID C. BIRDOFF

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P/S

United States Court of Appeals

For the Second Circuit

Docket No. 76-5020

IN THE MATTER
OF
F. O. BAROFF COMPANY, INC.,
Debtor.

AMERICAN BANK & TRUST COMPANY,
Plaintiff-Appellant,
against
EDWARD S. DAVIS, Trustee,
Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF PLAINTIFF-APPELLANT

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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-of-	:	
F.O. BAROFF COMPANY, INC.,	:	Docket No. 76-5020
Debtor.	:	
AMERICAN BANK & TRUST COMPANY,	:	
Plaintiff-Appellant,	:	
-against-	:	
EDWARD S. DAVIS, Trustee for the Liquidation of the Business of F.O. BAROFF COMPANY, INC.,	:	
Defendant-Appellee.	:	

PLAINTIFF-APPELLANT'S BRIEF

Preliminary Statement

Plaintiff-appellant American Bank & Trust Company ("American") appeals from an order of the Honorable Lawrence W. Pierce, United States District Judge, dated March 25, 1976, which affirmed an order of the Honorable Edward J. Ryan,

Bankruptcy Judge dated June 20, 1975, that had dismissed American's amended and supplemental complaint, and held, inter alia, that American was not entitled to share in the proceeds of an insurance claim received by the defendant-appellee Edward S. Davis, Trustee (the "Trustee") for the liquidation of the business of F.O. Baroff Company, Inc., pursuant to the Securities Investor Protection Act of 1970.

Issues Presented

Whether, by virtue of Section 167 of the Insurance Law of the State of New York insurance proceeds received by a Trustee on a policy obtained by a debtor or bankrupt, constitute an asset of the general estate, or a trust fund for the benefit of the unsatisfied creditor whose claim gave rise to the insurance payment.

FACTS

F.O. Baroff Company, Inc. ("Baroff") was engaged in business as a securities broker and dealer, and was a member of the National Association of Securities Dealers, Inc. ("NASD"). (3a, 231a, 243a)* In connection with the operation of its business, Baroff obtained a Brokers Blanket Bond from the Insurance Company of North America ("INA") (5a, 199a - 205a), which provided coverage against any loss sustained through (a) the dishonest or fraudulent acts of any employee; (b) forged signatures on securities; and (c) the transfer of stolen securities (199a, 200a).

In January of 1970, American and Baroff entered into an agreement pursuant to which American agreed to clear Baroff's purchases and sales of securities and to loan Baroff varying sums of money in connection with the operation of its business. (243a). As part of American's

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* Unless otherwise indicated, parenthetical references are to the Joint Appendix.

agreement to clear Baroff's securities transactions, American, at Baroff's request, agreed to place its "signature guaranteed" stamp on securities which had been sold through Baroff and upon which Baroff had guaranteed the signatures and endorsements of the registered owners. (11a).

As consideration for American's services, Baroff executed a Collateral Loan & Security Agreement ("Security Agreement") in favor of American, pursuant to which Baroff delivered and pledged to American negotiable securities, duly endorsed, as collateral for any indebtedness or liabilities, contingent or otherwise, it owed, or might owe, to American. (243a, 25a).

On January 6, 1972, by order of the United States District Court for the Southern District of New York, Baroff was placed in liquidation pursuant to the Securities Investor Protection Act of 1970. (243a). American

thereafter filed a proof of claim in the liquidation proceedings wherein, inter alia, it made claim for any loss, liability or damage which it might incur as a result of claims arising from certain clearance transactions relating to securities registered in the name of Esther I. Corey* (the "Corey claim"). (11a, 19a - 24a). The details of the Corey claim are set forth at pages 6 through 7, infra.

On January 6, 1972, when Baroff was placed in liquidation, Amrican was holding various negotiable securities that had been pledged by Baroff pursuant to the Security Agreement. (244a). American and the Trustee then entered into an agreement pursuant to which the securities were sold and the proceeds were placed in escrow pending a determination as to the validity of American's claims. (244a).

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* American also filed claim for unpaid loans and advances made to Baroff, interest thereon and its attorneys fees. (19a - 24a, 216a).

The Corey Claim

In April of 1971, certain certificates of stock owned by Mrs. Esther I. Corey, a Pennsylvania resident, and registered in her name were stolen from her. (244a). Subsequently, certain of the stolen certificates bearing Corey's forged endorsements were received and sold by Baroff which guaranteed the forged endorsements. Certain of Baroff's employees knowingly participated in the sale of Corey's securities (16a) and were subsequently convicted for mail fraud (206a).

American, at Baroff's request, in reliance upon Baroff's guarantee of Mrs. Corey's endorsements, and as part of its agreement to clear securities transactions for Baroff, placed its "signature guaranteed" stamp on the stolen securities. (12a). Checks totalling $270,352.85 were then drawn by Baroff, upon its account at American, payable to the order of Esther I. Corey. (12a). These checks were paid. (12a).

Esther I. Corey thereafter commenced an action in a Pennsylvania state court against the issuers of the stolen securities and their transfer agents concerning the wrongful transfer of her securities. (12a). The issuers and their transfer agents then "vouched in" American asserting it was obligated to indemnify them since it had placed its "signature guaranteed" stamp on the stolen securities. (13a).

In 1973, the Trustee moved to disallow American's claim with respect to the Corey transaction claiming that it was not allowable under the Bankruptcy Act. (217a). American opposed that motion and requested an order directing that certain of its claims be paid from the escrow and any balance remaining after such payment be applied towards any liability it might incur by virtue of the Corey claim. (216a). The Trustee opposed any application of the escrow funds to that claim arguing that it was not within the scope of the Security Agreement. (217a).

In June of 1973, the lower court heard oral argument on American's application regarding the escrow funds. (217a). On August 30, 1974 (14a) while that application was sub judice, American paid $180,449.58* to Esther I. Corey in full settlement of her claim. (217a).

In July, 1974, prior to settling with Corey, American commenced an adversary proceeding to compel

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* In 1971, prior to American's settlement with Corey, Baroff paid Corey for certain dividends she had lost on the stolen securities and arranged for the brokerage firm of Loeb Rhoades & Co. to return certain of her securities which that firm was holding for Baroff's account. As a result of the dividend payment and the reimbursement of Loeb Rhoades & Co. for the securities which were returned, Baroff incurred expenses totalling $14,369.41. (212a).

American's payment to Corey was unrelated to the securities and dividends returned to her by Baroff.

the Trustee to file a proof of claim under the Brokers Blanket Bond, since American had been advised that INA was willing to make full payment thereunder* if such a claim were filed. (2a - 8a).

Upon being notified of American's payment to Corey, the Trustee voluntarily instructed the Escrow Agent to pay American the balance of its collateral which was then $79,321.62, and withdrew his previous objections to both the allowance of American's claim against the General Estate of Baroff and the utilization of the collateral towards the Corey claim. (245a). After applying the remainder of the collateral, American's unsatisfied claim in connection with the Corey transaction was reduced to $101,127.95.

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* The maximum coverage afforded by the INA bond was $100,000.

On July 10 and September 18, 1974, after the institution of the adversary proceedings, the Trustee filed a claim under the INA bond in connection with the Corey claim and recovered $100,000, the maximum amount recoverable under the bond. (246a).

The Trustee refused to pay the $100,000 to American, notwithstanding the facts that American's unsatisfied claim was $101,127.95 and the $100,000 in insurance proceeds had been received solely by virtue of American's claim.

Statutes Construed

Section 167 of the Insurance Law of the State of New York provides in part as follows:

> No policy or contract insuring against liability for injury to person *** or against liability for injury to or destruction of, property shall be issued or delivered in this state, unless it contains in substance the following provisions ***.
>
> (a) A provision that the insolvency or bankruptcy of the person insured, or the insolvency of his estate, shall not release the insurer from the payment of damages for injury sustained or loss occasioned during the life of and within the coverage of such policy of contract.
>
> (b) A provision that in case judgment against the insured or his personal representative in an action brought to recover damages for injury sustained or loss or damages occasioned during the life of the policy or contract, shall remain unsatisfied at the expiration of thirty days from the serving of notice of entry of judgment upon the attorney for the insured, then an action may, except during a stay or limited stay of execution against the insured on such judgment, be maintained against the insurer under the terms of the policy of contract for the amount of such judgment not exceeding the amount of the applicable limit of coverage under such policy or contract.

* * *

POINT

SECTION 167 OF THE INSURANCE LAW OF THE STATE OF NEW YORK ENTITLES AMERICAN TO RECOVER THE ENTIRE INSURANCE PROCEEDS SINCE ITS CLAIM HAS NOT BEEN SATISFIED AND THE PROCEEDS DO NOT CONSTITUTE AN ASSET OF BAROFF'S GENERAL ESTATE

The lower courts held that notwithstanding the provisions of Section 167 of New York's Insurance Law, American was only entitled to recover $6,308.97 of the insurance proceeds although its unsatisfied claim exceeded $100,000 (228a-229a, 241a-254a). We respectfully submit that the lower courts were in error since (a) Section 167 of the New York Insurance Law gives American a direct interest in those insurance proceeds, and (b) the federal courts have held that by virtue of Section 167 and similar statutes, the proceeds of the policy do not inure to the benefit of the bankrupt's estate, but rather, title thereto vests in the injured claimant.

In 1918 the New York Legislature enacted what is now Section 167* of the Insurance Law to remedy the inequitable situation which had then existed when an injured person was unable to recover from an insolvent wrongdoer, even though the wrongdoer owned an indemnity policy.** Prior to the enactment of Section 167, the necessary condition for the accrual of the indemnity claim was actual payment by the wrongdoer. Where the wrongdoer was insolvent and unable to pay the injured party's damages no benefits could be obtained under an indemnity policy because there was no loss for the insurer to indemnify. "For the purpose of correcting

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* The provisions of Section 167 were originally enacted as part of Section 109 of the Insurance Law. L. 1918, Chapter 182.

** A contrary result was reached where the policy was one of "liability" as distinguished from indemnity. Under a liability policy, the obligation of the insurer to pay attached upon a determination that the insured was liable, whereas under an indemnity policy the insurer's obligation to pay did not arise until such time as the insured had paid the injured party. See, Harris v. Standard Accident and Insurance Company, 297 F.2d 627, 630-631 (2d Cir. 1961).

this situation with its attendant injustice, the Legislature enacted this remedial statute***." Jackson v. Citizens Casualty Co., 277 N.Y. 385, 389 (1938). As recognized by the District Court, the statute (a) was specifically enacted to protect the injured person and to provide him with a direct cause of action against the insurer upon the bankruptcy or insolvency of the insured (247a), Coleman v. New Amsterdam Casualty Co., 247 N.Y. 271 (1928), and (b) applies not only to liability policies but to indemnity policies as well (247a), Merchants Mutual Automobile Liability Ins. Co. v. Smart, 267 U.S. 126 (1925), 69 L.Ed. 538 (1925); Jackson v. Citizens Casualty Co., 277 N.Y. 385, 389 (1938); Coleman v. New Amsterdam Casualty Co., 247 N.Y. 271 (1928); Skenandoa Rayon Corp. v. Halifax Fire Ins. Co., 245 App. Div. 279, 281 N.Y. Supp. 193 (4th Dept.) aff'd 272 N.Y. 457 (1936).

Acknowledging the Legislature's purpose and intent in enacting such statutes, the United States Supreme Court has held that title to a bankrupt's liability or indemnity policy does not vest in its trustee,

but rather vests in the injured claimant, such as American. Merchants Mutual Automobile Liability Insurance Co. v. Smart, 267 U.S. 126, 137, 69 L.Ed. 538 (1925). Accord, Cissell v. Amer. Home Assurance Co., 521 F.2d 790 (6th Cir. 1975) cert. denied ___ U.S. _____, 96 S.Ct 857 (1976); Fix v. Automobile Club Inter-Insurance Exchange, 413 S.W.2d 194 (Mo. Sup. Ct. 1967); Fidelity Union Casualty Co. v. Hanson, 26 S.W.2d 395 (Tex. Ct. of Civil Appeals, 1930), aff'd 44 S.W.2d 985 (Tex. Comm. of Appeals, 1932), cert. denied 287 U.S. 599, 77 L.Ed. 522. See also, 3 Remington On Bankruptcy, §1251 (1957); In re Fay Stocking Co., 95 F.2d 961 (6th Cir. 1938).

Furthermore, upon bankruptcy, only the injured claimant is entitled to commence an action on the policy and not the bankrupt's Trustee. Cissell v. Amer. Home Assurance Co., 521 F.2d 790 (6th Cir. 1975), cert. denied ___ U.S. ___, 96 S. Ct. 857 (1976). As stated in Cissell, supra at 792:

> The injured party rather than a trustee in bankruptcy has the beneficial property right in a liability policy where the terms of the policy give the injured party a right of action against the insurer after obtaining a judgment against the insured. In re Fay Stocking Co., 95 F.2d 961 (6th Cir. 1938); cf. Hanover Insurance Co. v. Tyco Industries Inc., 500 F.2d 654 (3d Cir. 1974).

Title to the proceeds obtained under such a policy does not constitute an asset of the bankrupt's general estate but vests solely in the injured claimant. Merchants Mutual Automobile Liability Insurance Co. v. Smart, supra at 131; In re Fay Stocking Co., supra at 962-963; Fix v. Automobile Club Inter-Insurance Exchange, supra.

As stated by the United States Supreme Court in Merchants Mutual Automobile Liability Insurance Co. v. Smart, 267 U.S. 126, 131 (1925):

> The title to the indemnity passes out of the bankrupt or insolvent person and vests in him whom the contract and the state law declare it should vest. The assured is divested by the terms of the instrument under which the interest of the assured and the

> interest of the injured then contingent, and now absolute were created. The general creditors have lost nothing because by the fact of bankruptcy the interest of the assured in the policy passed to the injured person and did not become assets of the assured.

In construing similar statutes the federal courts have specifically enunciated the obligation of a bankruptcy trustee to hold in trust for the injured claimant the proceeds received under a liability or indemnity policy. In In re Fay Stocking Co., 95 F.2d 961 (6th Cir. 1938), the Court construed a liability policy (with a bankruptcy provision similar to the one at issue) and held that the bankrupt's interest in the policy did not constitute an asset of the bankrupt's estate. The court further held that if any insurance proceeds were collected by the Trustee he was obligated to pay those proceeds to the injured claimant, reasoning (95 F.2d at 962-63):

> We question whether the bankrupt's right to enforce this policy constituted property of the bankrupt within the meaning of the Bankruptcy Act. *** [O]nly such creditors as those whose claims against the assured

> arise out of personal injury covered by the policy in suit may assert a successful claim to the insurance fund, and the assured or its trustee, if either of them collects from the insurer, rests under a legal obligation to hold the funds collected in trust for the injured party. (Emphasis supplied.)

Although recognizing the validity of the foregoing authorities, the lower Courts inappositely concluded that American had an interest in, and was entitled to, only a portion of the insurance proceeds (i.e. $6,308.97), notwithstanding the fact that its unsatisfied loss totalled $101,127.96. In so holding, the District Court ruled that to the extent the Trustee had released the money in the escrow fund* to American, plus the previous payments which Baroff had made to Corey, American

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* It bears reiteration at this point that the Escrow Fund was created by the liquidation of certain securities held by American as collateral for Baroff's liabilities. The establishment of that fund did not constitute any relinquishment of American's status as a secured creditor (215a-216a).

was precluded from asserting any claim to the insurance proceeds. Thus, had American's claim not been partially secured, American would have been entitled to recover the entire proceeds.

In effect, the District Court held that partially secured creditors or creditors with partially satisfied claims, were to be afforded different treatment under Section 167 than ordinary creditors. Neither the statute nor the case law justify this differentiation. In fact, the statute provides that so long as a creditor's claim remains unsatisfied he has an interest in the debtor's insurance policy and the right to commence a direct action against the insurance carrier. In holding otherwise the District Court thwarted the entire purpose behind the enactment of Section 167 (i.e., to ensure that the insurance proceeds are utilized to satisfy the claim of the injured party) even though it specifically recognized that "the statute was to protect injured plaintiffs or third parties." (247a).

Ignoring the fact that the amount of American's unsatisfied claim exceeded the full amount of the insurance proceeds, the lower Courts nonetheless subtracted the amount of its collateral from the amount of the proceeds. The Courts thereby preferred the Trustee to the unsatisfied claimant despite the provisions of Section 167 and the pertinent case law.

To justify this preference, the lower Courts erroneously characterized American's applications of its collateral as a "loss" to Baroff's estate (249a). However, American's interest in its collateral, as a secured creditor, was superior to that of the Trustee. See, e.g., Lockhart v. Garden City Bank & Trust Co., 116 F.2d 658, 661 (2d Cir. 1940); In the Matter of Bernhard Altmann International Corp., 226 F.Supp. 201, 205 (S.D.N.Y. 1963). As a secured creditor, American, always had the right to utilize its collateral to reduce the amount of its claim against Baroff. See,

e.g., United States National Bank v. Chase National Bank, 331 U.S. 28, 33-34, 91 L.Ed. 1320, 1323-1324 (1946); In re Pennyrich International Inc. of Dallas, 473 F.2d 417, 421 (5th Cir. 1973).

The lower Courts neglected to consider that American's right to so apply the collateral had been given by Baroff as consideration for the banking services American rendered (25a). This right of a secured creditor is separate and distinct from American's right as an unsatisfied injured claimant under Section 167; these rights are mutually exclusive. By exercising its rights as a secured creditor American did not, as the District Court implicitly held (249a), elect to utilize its collateral in lieu of its right to recover the insurance proceeds. No such finding was made by the Bankruptcy Court and the record is barren of any facts to support such a conclusion.

In fact, the record demonstrates a contrary result. American commenced two separate actions below in connection with the Corey claim. The first, which

was commenced prior to June 1973, was to obtain an order allowing it to utilize its collateral in partial satisfaction of the Corey claim (216a-217a). The second was to recover the insurance proceeds to satisfy the unsecured portion of that claim. Both actions were strenuously opposed by the Trustee. Yet, it was not until after American instituted the second action that the Trustee finally conceded that American, as a secured creditor, was entitled to apply its collateral to the Corey claim. (216a - 217a). The Trustee then voluntarily instructed the escrow agent to pay the escrow funds to American (217a, 245a) and relied upon this payment to support his claim that he was entitled to the insurance proceeds.

The District Court's order is further belied by the fact that American could initially have recovered the insurance proceeds and then, as a secured creditor, resorted to its collateral to satisfy the unpaid portion of its claim. See Century Ins. Co. v. First Nat. Bank of Hughes Springs, Tex., 102 F.2d 726, 728-29 (5th Cir. 1939).

The District Court's conclusion that American somehow elected to utilize its collateral in lieu of the insurance proceeds is not only contrary to the undisputed facts, but is without legal precedent and is antithetical to the explicit language of Section 167, the legislative history thereof and the cases cited thereunder.

The lower Courts' decisions improperly shield the insurance proceeds from American simply because Baroff is in liquidation. Absent the liquidation, American could have enforced its claim against those proceeds since its collateral was insufficient to satisfy its claim. Thus, the lower Courts enabled Baroff to benefit from the fraud of its employee by retaining the insurance proceeds despite the fact that American suffered a substantial loss as a result of that fraud.

The lower Courts' decisions inequitably allowed general creditors, who were not defrauded and who had no claim under the bond, to share in the proceeds whereas the unsatisfied defrauded creditor, whose claim triggered

the payment of those proceeds, did not receive the full benefit thereof. See In re Fay Stocking Co., 95 F.2d 961, 962-63 (6th Cir. 1938). Such a result is antithetical to declared federal public policy requiring broker-dealers to maintain insurance covering employee theft and dishonesty. SEC Rule 15b10-11, 17 C.F.R. 240.15b10-11; NASD Rules of Fair Practice, Article II Sec. 32.* These requirements were enacted

> [a]s a result of a request made by the Securities Investor Protection Corporation ("SIPC") in mid-1971 that misappropriation of assets of NASD members through employee theft and dishonesty be excluded from the losses covered by SIPC, * * * . Securities Exchange Act of 1934 Release No. 11388 (May 1, 1975).

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* We recognize that Rule 15b10-11 and Section 32 of the NASD Rules of Fair Practice were enacted subsequent to the institution of Baroff's liquidation proceedings. We submit, however, that their enactment evidences an intent to protect injured parties, whose claims would not be covered by SIPC, through the utilization of insurance proceeds.

Under the Securities Investor Protection Act of 1970 (the "Act"), 15 U.S.C. 78aaa et seq., SIPC protection is afforded primarily to customers of a defunct broker-dealer to protect them against the loss or misappropriation of their property. Securities Exchange Commission v. Alan F. Hughes, Inc., 461 F.2d 974, 977 (2d Cir. 1972); H. R. Rep. No. 91-1613, 91st Conf., 2d Sess. (1970) as appears in Vol. 3 United States Code, Congressional and Administrative News, pp. 5254-57. The Act does not ensure customers against total loss but only within specified monetary limits. Section 6(f) of the Act, 15 U.S.C. §78fff(f). Non-customer creditors* or customers whose claims exceed the specified monetary limits are not afforded SIPC protection.

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* The Act does protect broker-dealers, but only with respect to "open contractual" commitments. Section 6(d) of the Act, 15 U.S.C. §78fff(d).

SIPC requested the NASD to study "bonding practices of the exchanges with a view to requiring similar coverage for NASD members" for losses resulting from employee theft or fraud not covered by SIPC protection. Securities Exchange Act of 1934, Release No. 11388 (May 1, 1975).* As a result of SIPC's request, brokers are now required to obtain bonds similar to the one at issue herein. Securities Exchange Act of 1934, Release No. 11388, supra. The Commission and the NASD, in promulgating those requirements, were concerned with protecting against

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* Under Rule 319 of the New York Stock Exchange, Exchange members are required to maintain brokers blanket bonds, similar to the one at issue herein. Congress has recognized that such bonds indirectly benefit a broker's customers only because they could not bring suit directly thereon against the insurer. Report of Special Study of Securities Markets of the Securities and Exchange Commission, Pt. I, H.R. Doc. No. 95 Pt. 1, 88th Cong., 1st Sess. 1, 87 (1963). However, as noted by the District Court (247a) under Section 167 a third party has a direct interest in the bond since he can directly bring suit against the insurer when the broker (insured) is insolvent or bankrupt.

losses sustained through employee defalcations which were not afforded protection under the Act. Securities Exchange Act of 1934 Release No. 11388, supra. Since the Act protects persons who have transacted business with brokers, rather than the brokers themselves, the bonding requirements must be viewed in that context. The lower Courts' decisions, when applied to liquidation proceedings today, would have an inequitable contrary result and benefit the broker whose employee defrauded an innocent third party.

In sum, the rights exercised by American as a secured creditor are separate and distinct from those afforded it under Section 167. Therefore, American did not waive its Section 167 rights when it utilized the collateral. Nor could the Trustee's acknowledgement of American's rights as a secured creditor constitute any such waiver.

Indeed, American does not assert, as suggested by the District Court (251a), that INA has any further liability on the bond. American solely seeks to recover the insurance proceeds now in the Trustee's possession which, as stated in In re Fay Stocking Co., 95 F.2d 961, 962-63 (6th Cir. 1938), are to be held solely for the benefit of American as the injured claimant.

CONCLUSION

For the reasons hereinabove set forth, it is respectfully submitted that the orders of the District Court and the Bankruptcy Court should be reversed and that American should be awarded summary judgment.

Respectfully submitted,

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STATE OF NEW YORK
CITY OF NEW YORK } ss.:
COUNTY OF NEW YORK

John J. Farrell, being duly sworn, deposes and says, that he is over 18 years of age. That on the 2nd day of July, 1976, he served 2 copies of the attached Brief on ~~the attorney for~~ the Security Investors Products Corp. herein by depositing the same, properly enclosed in a securely sealed post-paid wrapper, in a U. S. Post Office at 90 Church Street, New York City, directed to said ~~attorney at~~ party as follows:

Security Investors Products Corp.
Suite 500
Sarrazet Building
900 - 17th Street, N.W.
Washington D.C. 20006

that being the place where they maintain ~~their an~~ offices for the regular transaction of business, and the last address mentioned in the papers last served by them

John J. Farrell

Sworn to before me this
2nd day of July, 1976.

Leon Greenbaum

LEON GREENBAUM
Notary Public, State of New York
No. 24-4616700 Qualified in Kings Co.
Cert. filed in New York County
Commission Expires March 30, 1977

Service of three (3) copies of the within
is admitted this 2nd day of July 1976

Attorneys for Defendant-Appellee

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